

## WILL CHINA'S LOCAL DEBT CRISIS BREAK OUT? EVIDENCE FROM LOCAL GOVERNMENT FINANCING PRACTICE

**Ling Jiang & Yuwei Xu**

School of Economics,  
Southwest University of Finance & Economics. No.555,  
Liutai Avenue, Whenjiang District, Chengdu 611130. P.R.China.  
E-mail: jiangl@swufe.edu.cn  
E-mail: xuyuwei211@163.com

### ABSTRACT

*In recent years, as the developing and acceleration of the western sovereign debt crisis, the emerging market economies like China must take cautious measures to deal with such crisis because it has a huge impact on western society and the world economy. The paper analyzes the reasons of the local debt which increases rapidly with large scales and has varieties of debt with different characteristics. While the local debt at present is overall under control, the outbreak of local debt crisis is very high because the debt ratios in some regions and industries have reached more than 100%, the liquidity risk keeps highly due to reimbursement deadline, and the intensive activities of shadow banks which increase the risk of local debt. This paper aims to strengthen the management of China's local government debt and explore ways to reduce the local debt risks through policy making.*

**Key words:** *debt crisis local debt risk management*

## 1. INTRODUCTION

The global financial crisis in 2008 has made a major impact on the global economic and financial operation. The outbreak of sovereign debt crisis in the West represented by the United States and European Union is the continuation and deepening of the global financial crisis, which means the shift of the economic crisis from private financial institutions to government sovereign debt. The international trade, investment environment and external demand have appeared the corresponding deterioration and decline since the outbreak of the U.S. financial crisis and western sovereign debt crisis. Chinese government had launched the proactive fiscal policy and monetary policy like many other countries in the world, putting the focus on expanding domestic investment and consumption to promote economic growth, at the same time, the local government also had carried the corresponding investment which played a positive role in resisting the impact of the world financial crisis and maintaining the sustainable economic development. The focus of Chinese macro-economic control has changed under the proactive fiscal policy and prudent monetary policy and the local government debt in china has caused the attention of all parties, because the local debt scale expanded rapidly which resulting from the abundant of local government's investment and financing activities through the local financing platform and its transparency is very low, which all have large bad influence on China's financial system and even the whole macroeconomic system. The paper aims to analyze the causes of the local debt, the current situation, risk and the management to ensure the sustainable development of the national economics, and debt stability.

## 2. LITERATURE REVIEW

In recent years, the problem of local government debt has attracted the attention of scholars and practitioners. Some scholars believe that the imperfect fiscal system is the main cause of the rapid expansion of local debt. Zhao (2012) pointed out the unsound and missing financial and economic system, especially the incomplete tax sharing system are the fundamental cause of the local government debt. Chen (2013) indicated the increasing local debt lies in the local government department at the same level of finance that is too scattered, lacking of the fiscal supervision of local people's congress and has no institutional finance channels, leading to the creditor's rights abuse and the unclear segmentation between local government financial power and market. While Zhou (2007) thought the tax-sharing system conforms to China's national conditions and there is no causal relationship between local debt and the system. Some scholars pointed out the existing unreasonable government official achievement assessment system and economic incentives lead to the local debt increase rapidly (Wang and Guo, 2012). The research about local government debt risk think the China's local government debt at present is overall under control, the local debt crisis won't break out(Mina Jiang, Zhiwei Chai, Junpeng Zhan,2012), but the risk exists in the concrete to region, Zheng Xie chose western, central and eastern areas of China during 2007-2009 as sample data to analyze the existing local government debt risk, the results showed that the debt risk of local debt takes on a tendency to continuously go up(Zheng Xie, Guangyan Chen,2012).Xing Liu and Yi Liu (2006) argued that the local debt risk reflect in scale, structure and benefit of the debt. China's scale risk is serious, the foreign debt, contingent liabilities and recessive debt problem are outstanding and the benefit risk of local debt shows an obvious growth trend. About the management of local debt risk, Haitao Ma, Jinhua Ma (2011) proposed the fundamental solution for local debt problem lies in realizing the local debt securitization,

and ultimately makes local debt management transparency, legalization, marketization, standardization and so on. Kun Yan, ShuyiYu (2012) argue that establishing an effective financing mechanism of local government debt should contain five aspects that are revision of relevant laws giving local government independent right to issuing bonds, controlling the total amount of debt, optimizing the debt structure and eliminating the institutional obstacles.

In summary, these scholars have carried an extensive discussion on the reasons, risks, and management of the local government debt. This paper aims to use the latest local debt statistics released by China National Audit in 2013, on the basis of existing research to analyze the present situation of local debt and discuss the possibility of local debt crisis and put forward several local debt management policy recommendations.

### **3. THE CURRENT SITUATION OF LOCAL GOVERNMENT DEBT IN CHINA**

#### *3.1 Local government debt is large in scale, rapid development, but still governable*

According to the latest data released by the Audit Commission, by the end of June 2013, the local government bear the responsibility to repay the debt is 10.88 trillion Yuan, the debt of which liable for guarantee is 2.67 trillion Yuan and may be response for some rescue is 4.34 trillion Yuan. If the local government contingent liabilities are included, at the end of 2010, 2012 and June 2013, the amount of local government debt in China have reached 10.7 trillion Yuan, 15.89 trillion Yuan and 17.89 trillion Yuan(see Table 1), as a share of GDP is 26.7%, 30.6% and 33%.

According to the statistics of the National Audit Office, the scale of China's local government debt increased year by year since 1997. The debt balance increased by 48.20%, 61.92% and 48.50% respectively in 1998, 2009 and 2012, and the first half of 2013 grew by 12.59% over 2012. Figure 1 shows that the growth rates of China's local government debt balance are all over 20% since 1997, much higher than China's GDP average growth rate of 10%. Although the growth rate of China's local debt is very fast, the total amount of local debt is still under control. By the end of 2012, the debt ratio of the debt obligation is 39.43%, including contingent liabilities, and the generalized ratio is 53.5%, lower than the international commonly used 60%. The government foreign debt balance is 473.358 billion Yuan, accounting for 0.91% of GDP, below the 20% reference value of international control standards commonly used. Therefore, the China's local government increases rapidly and has a large scale, but still manageable.

#### *3.2 The Characteristics of Borrowers and Debt Sources*

Governments at all levels like provincial, municipal, county and township all have liabilities. The provincial government's debt balance is 5.19 trillion yuan, accounting for 29.03 percent of total local debt, slightly lower than the one in 2010. The municipal government's debt balance is 7.29 trillion yuan, accounting for more than 40.74%, 2.77% lower than the one in 2010; the debt balance of country is 5.04 trillion yuan, accounting for 28.18%, 1.65% higher than the debt in 2010.

In addition, according to the National government debt audit results in 2013, the village and town governments begin raising debt since 2013 and the amount is 0.36 trillion yuan, the proportion is 2.04%.The size of municipal debt is largest but has a tendency to decline, the size of the debt at the country and provincial level is similar. Table 2 shows all kinds of creditor, the financing platform companies and government departments take the dominant position, accounting for 61.65% of total

financing, 8.04% lower than in 2010 ,because the central clean up local government platform companies lead to credit tightening. The local governments run up the debt 3.14 trillion yuan from state-owned or controlled enterprise, which lead state-owned enterprises to become the third largest debt principal inferior to the financing platform company, government departments and agencies.

Regarding to the source of the debt, bank loans, BT and bond issuing are the main channels for the local government to get the capital about 10.118739 trillion yuan, 1.476351 trillion yuan, and 1.845691 trillion yuan, accounting for 56.56%, 8.25% and 10.32 % , respectively. The proportion for bank loans falls from 79% in 2010 to 56.56%, showing the tendency that the local government will reduce the dependence on bank. At the same time, the importance of shadow banking such as trust financing and BT increase gradually. From the using of the debt and the term of payment, 86.77% of the capital investing in infrastructure and public welfare projects, by the end of 2013 and 2014, the local governments have to repay the debt accounting for 22.92% and 21.89% .

### *3.3 Lack of solvency mechanism, relying too much on land value*

China's local governments don't have a sound mechanism for debt repayment and rely on land revenue seriously. NO.32 of the National Audit Office's audit results in 2013 showed that the local government including 11 provincial governments, 316 municipal governments and 1396 county governments promised to use the revenue from the sale of land to repay debt 3.49 trillion Yuan by the end of 2012, accounting for 37.23% of the total for the governments at the three levels. The local governments take the future revenue, the profit of solid using in constructing and land as collateral to borrow. Only if the economy keeps high growth rate in the future and the land value won't depreciate, the mortgage guarantee is successful. In the process of land mortgage, the assessed value of land is often overrated, and the land price rising is a kind of expectation which may not be fully attained.

## **4. THE CAUSE OF THE DEVELOPMENT OG CHINA'S LOCAL DEBT**

### *4.1 Tax sharing reform increasing the burden on local government*

Since the system reform of tax distribution of China in 1994, most of the tax revenue controlled by the central government, while more duty are transferred from the central to local, which makes a huge gap between the demands for funds and their income for local governments. During 1994-2008, the allocation ratio of the tax revenue between the central and local is 13:12, while the obligation ratio is 3:7. Figure 2 shows the situation of local fiscal revenue and expenditure during 2004-2012. It clearly shows that the responsibility borne by local government is increasing; financial income is relatively slow, leading to the local fiscal deficit bigger and bigger. Therefore the local governments at all levels have to raise debt through various channels under the fiscal pressure.

### *4.2 The imperfect local debt system*

At present, China's local government debt system has defects in following several aspects. First one is the lack of the overall management system about debt, resulting in the specific situations of the debt such as the maturity structure, distribution and repay source are all fuzzy. Second, there is no uniform way for local government to count the debt, and no reasonable debt repayment mechanism. Third, the lack of independent and authoritative credit rating agencies, strict and normative information disclosure system and professional guarantee mechanism all increase the debt risk in some extent. The

fourth is short of specific regulations for the hidden financing platform to realize the standardized management.

#### *4.3 Stimulation of existing performance evaluation mechanism*

Under China's current economic system, the local economic growth rate and public infrastructure construction are the major indexes of the performance evaluation of local government officials, which also are the important basis of official promotion. The local officials vigorously promote the local economic and social development by using the excessive financing capital in their tenure to achieve better performance and political interests, without considering the long-term development of the local economy and also resulting in the disorderly competition between local governments. On the other hand, the local debt scale and repay ability don't make an important role in official performance evaluation which in some extent encourages officials to seek various financing channels to raise the local debt. In addition, the legal term of local officials is five years, and the average tenure of city level is three years, so under the tenure limits, most of the debt in current time will be repaid by the next administration. Even the amount of debt is so large that the local government couldn't deal with, they can find the central government for help. So one-sided pursuit of achievements, unconstrained repayment liability requirements and the inter-temporal malignant metastases all will enlarge the debt scale and increase the probability of debt crisis.

### **5. RISK ANALYSIS OF LOCAL DEBT**

Lin Guo (2001) argues that the local government debt risk refers to various problems due to the uncertainty, the defect of the debt, and the impacts of those on economics, politics and society. In a sense, those problems are the manifestations of the local debt risk. While the risk is under control generally speaking at present, but it does not mean that there is no risk at all, certain areas and industries are facing severe risks to repay the matured debt, which indicates that the partial crisis will become the national economic crisis careless slightly.

#### *5.1 Large probability of certain areas' crisis*

By the end of 2012, there are 99 municipal governments, 195 county governments and 3465 township governments bear the debt ratio of the being responsible for repaying is higher than 100%, some which receive 188.95%. If the guaranteed debt is counted, the highest debt ration can reach 219.57%. The debt service ratio exceeds 20% for 13 provincial capital cities; the highest reach 60.15%, if the secured debt is included and the highest ratio can reach 67.69%. According to the audit results of the 36 local governments, some provincial capital cities have the high debt ratio and debt service ratio due to the shortage of solvency, which lead to raise the new debt to repay the old. In 2012, 5 provincial capital cities bear the ratio of borrowing new debts to repay the old exceed 20%, the highest reaches 38.01% and 14 provincial capital cities have 18.17 billion yuan which beyond the repay time, the overdue debts ration of two provincial cities have exceed 10%, with the highest ratio of 16.36%. If the government regulate the local risks ineffectively, these risks existed in some areas will spread to other places by a chain reaction due to the interaction between various types of debt risks.

#### *5.2 The liquidity risk of local debts*

Since 2009 the outstanding feature of the local government financing is that all capital has invested in the construction of infrastructures which generate no benefits in short time or forever. "More than 70% of the projects are unproductive" one report of bank said. We know that the local governments

often promise to repay the debt in three to five years after borrowing, which means the fastigium of repaying is coming. By the end of 2014 and 2015, the government has to repay 2.3 trillion and 1.8 trillion, accounting for the proportion of the stock of the real debt 21.9% and 17.1%. If we take the contingent liabilities into consideration, the due amount will reach 3.6 trillion and 2.8 trillion. The short-term repayment cycle brings the enormous pressure. Although the development and reform commission (NDRC) allow the local to raise the new debt to repay the old one, which only is the expedient measure to balance the debts and economic development and extend the debt maturity, the debts won't disappear.

### *5.3 The risk from the shadow bank*

The data of National Audit Office shows that the proportion of bank loans fall to 57% by the end of June 30 in 2013 from 79% in 2010, the ratio of bonds rises to 10% from 7% and the trust financing from zero to 8%, the other financing beyond the limits of lending policy accounting for 25%. Local governments look for the shadow banks for help gradually as the bank tightening credit, which will increase the cost of financing and exceed the repaying ability of some low-level City Infrastructure Investment Corporation, increasing the possibility of debt default. The shadow banks concentrate on short-term loans, which further exacerbate the debt repayment period mismatch.

## **6. RETHINKING OF PREVENTING AND RESOLING THE DEBT RISK**

According to the audit report about local government released by the Audit Commission, by the end of June 2013, the national local government debt balance is 17.89 trillion yuan, which the local government bear the responsibility to repay the debt is 10.88 trillion Yuan, accounting for 60.84%; the debt of which liable for guarantee is 2.67 trillion Yuan accounting for 14.9% and the debt may be response for some rescue is 4.34 trillion Yuan accounting for 24.25%. As the China strengthening regulation on the real estate market, the "land finance" will difficult to continue survival. The decreasing of income from transferring the land would make a considerable effect on the fiscal revenue and debt repaying, which will make the government debt risk gradually revealed.

In view of this, the state introduced new regulations recently concerning the administration of the local government debt, which shall be conducted in combination of administration by classification, differential treatment and dissolving gradually. Further making the local financing platform standard and prohibiting all forms of illegal guarantee commitments. Meanwhile, the short-term response measures and long-term system construction should be combined, establishing a sound system of local debt management, strictly controlling the new debt and building the mechanism of debt scope management and risk warming, classifying the debt payments into the budget management. The following are the specific thinking.

### *6.1. Clearing responsibilities between the central and local governments*

First, the financial power between central and local governments must be allocated accordingly with duties. A clear division of power and responsibilities is to ensure the functions of local government "onside, located correctly and no absence" and such division is also the important basis for the appropriate configuration of power and financial resources.

Second, policies must base on the market economy system and public finance framework, following the basic rules of dividing the power, referring to the usual practice of market economy, forming a relatively standardized and transparent partitioning patterns using in dividing the management authority

and expenditure responsibilities in the field of education, health and an social security, and fixing it in the form of law in the field at last.

Third, according to the principle of matching the power and responsibility, the local government should have appropriate tax autonomy to expand the tax base and can decide the tax rate and have more voice and participation right about some shared tax. In some places, the management authority of local tax also can be transferred to local government without affecting the distribution pattern and economic development.

## *6.2 Improve the system of local debt management*

### *6.2.1 Standardizing local financing platform.*

According to the Audit Commission's figures, 38.96% of the China's local government is from local financing platform with a lot of hidden debts. One of the reasons is that the local government borrows simultaneously money from multiple financing platforms and multiple banks. Because it is difficult to understand the overall liabilities of the government, to some extent, banks loose the debt audit standards. At present, few relevant laws strictly regulate local financing platform. Simultaneously, local governments consciously or unconsciously, to loosen related controls about the financing platform in order to achieve financing. Therefore, it is essential to develop a unified relevant norm for local financing platform by the state in order to prevent local governments weakening the enforcement of norms for their own interests.

### *6.2.2 Finding out the real situation and improving transparency.*

It is the premise and foundation for effective management of finding out the real scale of government debt. Therefore, local governments should change their concepts and strengthen information disclosure and its quality. Meanwhile, Because of hiding information, local governments have a variety of implicit debts. So local governments should effectively promote them changing into explicit debt and disclosed timely to the public. Thus it can change the current status of the opaque seriously disclosure.

### *6.2.3 Designing practical mechanism for financing and debt repayment.*

In order to reverse the over-reliance on the land, the local government should be given appropriate claims. In 2011, Shanghai, Zhejiang, Guangdong and Shenzhen have set places to issue bonds. Although the pilot projects carried out in only a small area and its effectiveness remains to be seen, it may well be one alternative method to resolve the debt. The pattern such as BOT, BOOT can also be applied in the infrastructure sector.

### *6.2.4 Supporting and standardizing credit rating agencies.*

For the target of implementation of the responsibility system of government financing platform, the lending activity and debt scale of the platform must match with the local government's fiscal strength, and the debt maturity must be consistent with the government's term of office. According to the previous research results of government liabilities, one reason for large scale debt and repay risk is that the government official focuses on pursuit of performance regardless of the actual strength. On the basis of the implementation of debt responsibility, it is necessary to carry out the project management system. When the liability behavior of government financing platform is independent, the project management system can more effectively implement the responsibility main body, and improve the efficiency of using the debt capital. For the public welfare projects of government, the project leader must determine the

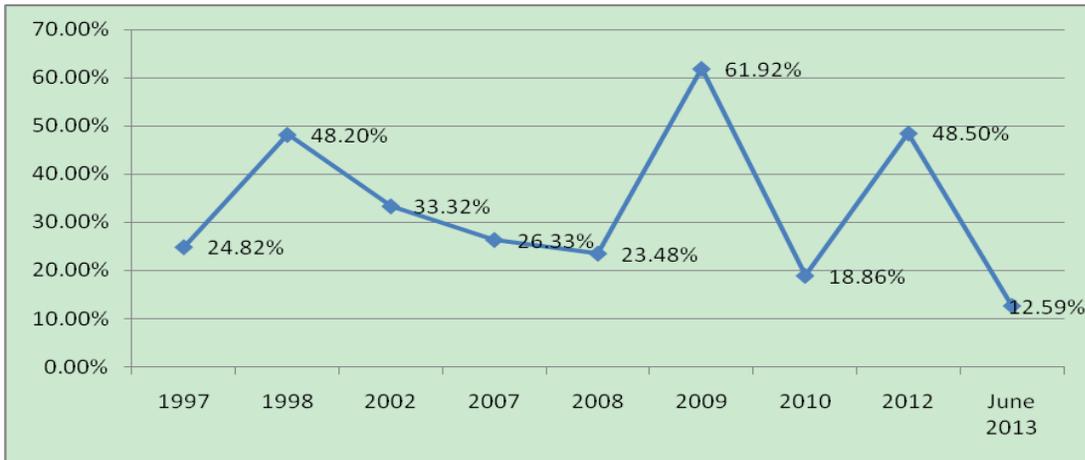
commitment letter issued by the Municipal Finance Bureau, according to the scope and process approved by the local People's Congress to ensure the source of the capital.

### *6.3 Implementing the budget financing system and setting up debt service reserve*

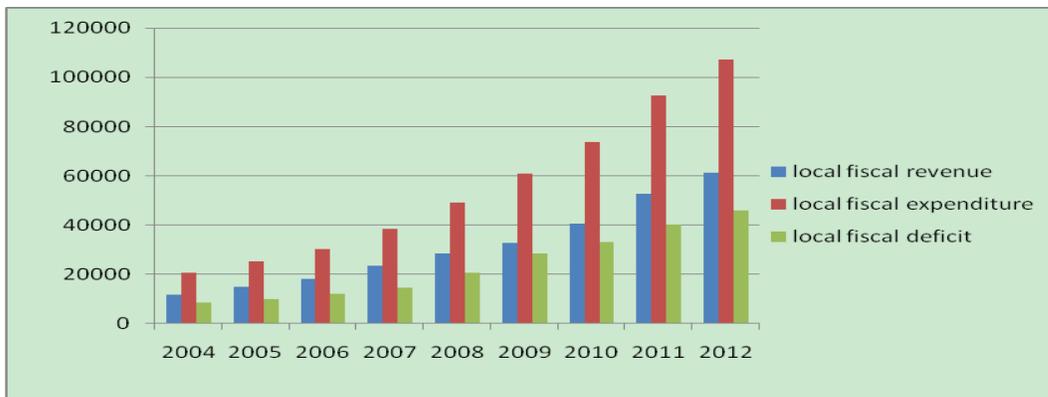
On the basis of the integration of the government financing platform, implementing the budget financing system, setting up the annual funding plan management system for local governments is an effective measure to regulate government financing platform to prevent from the government debt. Capital budgeting means that at the beginning of this year, according to the needs of economic and social development, urban construction and the government's ability to repayment, considering of the principle of moderate debt, for example, the debt ratio less than 100% of the revenue, determining the size of the government's annual financing scale to prevent excessive disorderly borrowing. In addition, the debt service reserve funds like the deposit insurance system of the United States should be established under the leading of the provincial public finance departments. The capital resource of debt service reserve funds are divided into two parts: one is a proportion of risk fund extracted from the debt funds; second, certain provisions extracted from the special financial funds by financial departments, especially the provincial level. The purposes of debt service reserve is to guarantee compensation possible insolvency risk of the interest expenses of financing platform to prevent the emergence of the capital chain rupture, not for repay the debt of financing platform. The establishment of debt service reserve funds is of more symbolic than practical significance. By the end of June 2013, 28 provincial governments, 254 municipal governments and 755 county-level have established the debt service reserve system, the reserve balances has RMB 326.55 billion yuan.

### *6.4 Regulating the behavior of borrowing and strengthening the cooperation of the banks and enterprises*

The debt of the local government financing platform mainly comes from bank loan, therefore, regulating the debts should focus on how to use the bank's risk controlling measures, strengthening the communication and cooperation between the bank and the enterprise of the financing platform, and letting the enterprise to assist the bank to control the credit risk. The present situation tells us that the bank takes the excessive risks of the debt and it is the largest creditor of the government financing platform. Therefore, strengthening the cooperation of bank and enterprises is the most direct and efficient way to standardize the construction of the government financing platform and prevent the government against the debt risk. In fact, bank and other financial institutions do better than any other companies at the controlling of the risk. Besides, they have set up an effective risk controlling system and debt capital supervision system. In essence, the management mechanism of the government financing platform, banks and other financial institutions are the same. Therefore, to standardizing government information disclosure and financial conditions of financing platform with the support of bank can quickly achieve the target of debt risk control of financing platforms through market.



**FIGURE 1: Growth ratio of local government debt since 1997**



**FIGURE 2: Local financial revenue and expenditure in China during 2004-2012**

**TABLE 1 :Scale of local government debt** Unit: trillion Yuan

year	Responsible debt	Contingent debt		Total
		Guaranteed debt	Rescued debt	
End of 2010	6.71	2.34	1.67	10.72
End of 2012	9.63	2.49	3.77	15.89
End of June 2013	10.88	2.67	4.34	17.89

**TABLE 2 :The debt principle of local government debt balance by the end of June 2013**

Debt principle	Financing platform company	Government departments and agencies	Funded situations	State-owned or controlled enterprise	Independent institutions	Utilities	Others
Debt (trillion yuan)	69704.42	40597.58	23950.68	31355.94	6025.46	3280.52	3994.06
Proportion	38.96%	22.69%	13.39%	17.53%	3.37%	1.83%	2.23%

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